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CSDR MANDATORY BUY-IN REGULATIONS: WHAT THE FALLINGS-OUT ARE ABOUT

Mandatory buy-ins are one of the most controversial rules in the EU Securities Market that are set to enter into force in the near future. Ever since their adoption, the regulators and the industry participants have been in strong disagreements about their effectiveness for ensuring the safety of securities settlement systems, as well as on potential risks they present. The controversy and the issues arising from the regulations led the European Securities Market Authority (ESMA) to postpone their commencement several times. The regulations were expected to enter into force in September 13 of 2020 but were postponed to 1 February 2021 to provide the affected entities with additional time for preparation.[1] Due to the hardship caused by the COVID-19 pandemic, ESMA decided to further postpone their commencement date to 1 February 2022.[2]

Curious about the debate between regulators and policymakers on one side and market participants on the other, this article seeks to make some sense of the controversy surrounding the mandatory buy-in regime. We shall start with presenting the regulatory background and summarizing the mandatory buy-in measures provided under the 2014 EU Central Securities Depositories Regulation (also referred to as "Level 1 Regulation" or "CSDR") and the 2018 ESMA regulatory technical standards on settlement discipline (also referred to as "Level 2 Regulation"). We shall then proceed with apprehending and evaluating some of the common arguments presented both by the regulators and the industry participants for and against the regime.

GENERAL INFORMATION ON THE LEGAL FRAMEWORK: WHAT ARE MANDATORY BUY-IN RULES UNDER CSDR?

Well-functioning and safe securities settlement systems are a key component to sound financial markets as they carry out the enforcement of most trades with financial instruments. In simple terms, a securities settlement system is an arrangement between participant financial institutions for executing securities transfer orders between them. It ensures that following trade the securities are actually delivered to the respective party of the deal either free of payment or conditional on payment[3]. Such systems are usually operated by a central securities depository (CSD).

Acknowledging the major role securities settlements systems play in the functioning of financial markets, in 2014 the European Parliament and the Council adopted Regulation No 909/2014 on improving securities settlement in the European Union and on central securities

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32020R1212

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32021R0070

[3] Legal definition of securities settlement system may be found under Article 2 (1) point 10 of Regulation No 909/2014 and under first, second and third indents of point (a) of Article 2 of Directive 98/26/EC; BIS has a simple definition in its glossary: https://www.bis.org/cpmi/publ/d00b.htm?&selection=63&scope=CPMI&c=a&base=term

depositories. Having increased safety and efficiency of securities settlements as one of its primary objectives the regulation among other rules provides settlement discipline measures to prevent settlement fails in the system. Ideally settlements should take place within a short period following trade but occasionally they fail due to various reasons often causing damages to either or both parties of the trade. Often failure to settle one transaction causes settlement failures in one or multiple other transactions creating so called daisy chains of settlement fails. This happens for example when Company A relends securities it has borrowed from Company B to Company C and Company C fails to timely return the securities causing Company A to default on its obligation to deliver the securities to Company B. For this and several other reasons high settlement fail rates affect not only parties to a particular trade but also the functioning of financial markets as a whole.[4]

Securities settlements failures occur for a number of reasons which can conditionally be classified into two groups:

Failures due to issues related to clients: a) Seller is not able to deliver the securities either due to the unavailability of the securities in the market or cascade of failures, where the seller was expecting to receive the same securities from another person but was failed to, or the deliberate behavior of the seller motivated by the possibility to use the security in another trade and gain more profits or for any other reason. b) Buyer does not deliver cash. c) Operational issues within the buyer or seller organization such as miscommunications between the front and back office, miscommunication between the responsible departments of the seller and the buyer, erroneous standing settlement instructions or other disruptions.[5]

Failures due to issues related to the securities settlement system: Operational issues within the participants of the securities settlement system or the Central Securities Depository.

Having talked about the importance of preventing settlement fails and the primary reasons of their occurrence, we shall now turn to the actual picture, namely the statistics on frequency of settlement fails. One might assume that there would be no additional regulatory intervention with so much cost if the systems were all running smoothly, which the numbers show is not exactly the case and that there is some room for improvement. In June of 2019, the settlement failure rate was around 1.5% of trade value for government bonds, above 3% for corporate bonds and around 8% for equities.[6] The pandemic further increased those rates, which reached their record high in March of 2020 with almost 6% for transactions with government bonds, around 5% for those with corporate bonds and close to 14% for those with equities. Following March, frequency of settlement fails in all three categories of securities has decreased and as of December 2020 returned to pre-pandemic levels for bonds both government and corporate, but still remained considerably high for equities.[7]

Due to the serious impact the settlement failures may have on the functioning of the financial

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[4] See FEDS Notes on The Systemic Nature of Settlement Fails https://www.federalreserve.gov/econres/notes/feds-notes/the-systemic-nature-of-settlement-fails-20170703.htm

[5] https://www.ecb.europa.eu/pub/pdf/other/settlementfails042011en.pdf, p. 2-3

[6] ESMA Report on Trends, Risks and Vulnerabilities No. 2, 2019, p. 16 https://www.esma.europa.eu/sites/default/files/library/esma_50-165-883_report_on_trends_risks_and_vulnerabilities_no.2_2019.pdf

[7] ESMA Report on Trends, Risks and Vulnerabilities No. 1, 2021, p. 20 https://www.esma.europa.eu/sites/default/files/library/esma50-165-1524_trv_1_2021.pdf

markets, the Level 1 Regulation provides a mandatory toolkit called the settlement discipline regime (SCR) designed for preventing and addressing those failures. As delegated by the Level 1 Regulation, ESMA sets some of the details of SCR in its Level 2 Regulation. The regime applies to the settlement of the following financial instruments: transferable securities, money-market instruments, units in collective investment undertakings and emission allowances.

Before we turn to the primary measures envisaged by the SCR, a small caution on our part: while going through the summary of the SCR rules, notably the mandatory buy-in section, our guess is that readers not familiar with those rules are going to be confused. Good news is that after reading the third section of this article, they will understand that their confusion is valid since the feedback given by the stakeholders of the securities market shows that the whole industry is pretty much confused.

1. Confirming information on transactions to be settled

Level 1 Regulation requires investment firms to have agreements in place with their professional clients "to ensure the prompt communication of an allocation of securities to the transaction, confirmation of that allocation and confirmation of the acceptance or rejection of terms in good time before the intended settlement date".[8] Information that shall be communicated includes the type of the transaction, identifier of the financial instruments to be delivered, trade price, intended settlement date and other.[9] Level 2 Regulations also require investment firms to collect information from their retail clients unless client holds the relevant financial instruments and cash at the same investment firm.[10] The idea behind these requirements is that investment firms should timely collect information from their clients that is necessary for settling the transaction.[11]

2. Monitoring and reporting incidents of securities settlement fails

CSDs shall implement systems that enables them to monitor the number and value of settlement fails. Information on settlement fails shall be periodically communicated to the competent authority, namely the authority responsible for authorizing and supervising CSDs in a particular member state, and to the relevant authorities. The list of relevant authorities is published by ESMA. To ensure transparency, CSDs shall also publish aggregated data on the number and value of settlement fails.[12]

3. Cash penalties

CSDs shall have penalty mechanisms against participants that cause settlement fails and which shall apply to all failed transactions.[13] The purpose of the penalties is to serve as an effective deterrent. One might wonder what happens if the transaction was failed at client's fault for example due to lack of securities or cash? In those circumstances CSD participant financial

[8] Regulation No 909/2014, Article 6 paragraph 2
[9] COMMISSION DELEGATED REGULATION (EU) 2018/1229 of 25 May 2018, Article 2
[10] Id., Article 3
[11] Id., recital 4
[12] Regulation No 909/2014 Article 7 paragraph 1, Articles 11 and 12
[13] Regulation No 909/2014, Article 7, paragraph 2; COMMISSION DELEGATED REGULATION (EU) 2018/1229 of 25 May 2018 Article 12

institutions recharge those amounts to their clients.[14]

4. Mandatory buy-ins

Having summarized other general measured provided under the SCR, we shall now turn to the main topic of our article, mandatory buy-ins. Although neither Level 1 nor Level 2 regulations define what a mandatory buy-in is, one infers from Article 7 of the Level 1 regulation that a buy-in is a process where financial instruments that were not timely delivered to the receiving participant are delivered to the receiving participant, presumably by a person other than that, who caused the settlement fail (usually a buy-in agent). If the price of the financial instruments that was agreed at the time of the trade exceeds the price paid for purchasing the securities from the buy-in agent, the failing participant shall pay the difference to the receiving participant.

In circumstances where the buy-in fails or is not possible the receiving party may choose among the two following options: 1) postpone the execution of the buy-in to a later date 2) receive cash compensation. If the financial instruments are not delivered on the designated later date, cash compensation shall be paid to the receiving participant.[15]

One shall be cautious in order not confuse participants of the securities settlement system with the actual trading parties, although occasionally they do coincide. Trading parties are the persons parties to the securities transaction that is being settled by the securities settlement system. Participant is an institution that participates in the securities settlement system and that is responsible for “discharging the financial obligations arising from transfer orders within that system”[16]. Think of it as someone buying a house and transferring the purchase price to the seller’s bank account. The buyer and the seller of the house are the equivalents of the trading parties, the banks of the seller and of the buyer are the equivalents to participants. Does it not sound odd that in case the buyer fails to timely transfer the purchase price to the seller’s bank account, the buyer’s bank shall be responsible for compensating the seller’s bank? Apparently that is what the Level 1 Regulation says in its provisions about mandatory buy-ins. Would it not be more logical if buyer had to compensate the seller? That is what ESMA attempted to do in its Level 2 regulation by shifting the execution of a buy-in from the settlement level to the trading level.

Level 2 Regulation contains general rules that are applicable to all buy-ins and specific rules that vary depending on whether the buy-in is for transactions cleared by a CCP, for transactions not cleared by a CCP and executed on a trading venue and for transactions that are neither cleared by a CCP nor executed on a trading venue. General rules define the circumstances, where the buy-in is considered as not possible or ineffective, set the requirements for the buy-in agent, as well as the requirement for the parties in the settlement chain to have contractual arrangements with their relevant counterparties to enable the smooth operation of the buy-ins.

We shall now turn to the specific rules.

a) Transactions cleared by a CCP

[14] https://www.esma.europa.eu/sites/default/files/library/2016-174_-_final_report_on_csdr_rts_on_settlement_discipline_0.pdf , point 74
[15] Regulation No 909/2014, Article 7, paragraph 7
[16] DIRECTIVE 98/26/EC, Article 2 (b)

For such transactions CCP is the entity responsible for organizing the buy-in process, which it may do either by starting an auction or appointing a buy-in agent. Should the buy-in be fully or partially successful, the CCP is responsible for accepting and paying for the bought-in financial instruments and delivering them to the receiving clearing members. The cash compensation for instances, where the buy-in was impossible or failed, as well as the price difference of financial instruments that was agreed at the time of the trade and the actual amount paid for buying in those instruments shall be collected by the CCP from the failing clearing members and paid to the receiving members.[17]

b) Transactions not cleared by a CCP and executed on a trading venue

For such transactions where the buy-in is deemed as possible the receiving trading venue member is responsible for appointing a buy-in agent. Where the buy-in is successful, the receiving trading venue member is under the obligation to accept and pay for the bought-in financial instruments. The cash compensation and price difference shall be paid by the failing trade venue members to the receiving members.[18]

c) Transactions not cleared by a CCP and not executed on a trading venue

The receiving party is responsible for appointing a buy-in agent and where the buy-in is fully or partially successful, for accepting and paying for the bought-in financial instruments. The cash compensation and price difference shall be paid by the failing trading parties to the receiving parties.[19]

MAIN CONCERNS RAISED BY THE INDUSTRY AND OUR OBSERVATIONS

a) Price distortion and market liquidity

A number of stakeholders, including the International Capital Markets Association (ICMA) has expressed concerns with respect to price distortions that may potentially be created by mandatory buy-ins. As ICMA explains, the price of executing a buy-in is generally higher than the fair market value of the bought in securities partially due to the reason that buy-in signals the market that securities will be purchased no matter what the price. This effect is further exacerbated for illiquid securities, where the mandatory nature of the buy-in creates additional demand.[20] On the other hand it is not clear whether and how often actual settlement fails and buy-ins shall be communicated to the market since while purchasing securities from the market in order to deliver them to the “failed to” buyer, the appointed buy-in agent is not necessarily going to lay all its cards on the table and advertise itself as a buy-in agent looking for securities to execute a buy-in.

Some claim that market participants will be more reluctant to lend due to the risk of being bought in and being subject to the expenses of the buy-in, which will adversely impact liquidity.[21]

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[17] COMMISSION DELEGATED REGULATION (EU) 2018/1229 of 25 May 2018, Articles 27, 33 and 35

[18] Id., Articles 29, 33 and 35

[19] Id., Articles 31, 33 and 35

[20] Buy-ins, how they work, and the challenge of CSDR An ICMA briefing note July 2015, p. 5

[21] ISLA’s response to Consultation on Technical Standards on the CSD Regulation. The Operation of the Buy-in Process dated 30th June 2015, p. 3

b) Lack of definition of a buy-in

The next frequently raised concern is that neither Level 1 nor Level 2 regulations contain a precise definition on what a buy-in is. ICMA is not sure whether buy-ins, as provided under the regulations, are contractual remedies for restoring both counterparties to the economic position they would be in if the transaction settled or are they penalties to punish the failing counterparties? Perhaps this confusion arises from the mandatory nature of the buy-in. Contractual remedies are voluntary in nature meaning that the non-breaching party may elect to exercise them or not, whereas the buy-ins as provided under the regulation are not optional. Another reason for the confusion may be the explanation of a buy-in set under Article 7 of the Level 1 Regulations: "Without prejudice to the penalty mechanism referred to in paragraph 2 … a buy-in process shall be initiated whereby those instruments shall be available for settlement and delivered to the **receiving participant** within an appropriate time-frame". The same regulations define a participant as a participant in a securities settlement system. If the buy-ins were designed as a contractual remedy, they would focus on delivering the securities to the receiving trading party rather that the participant in the settlement system. At the same the phrase "Without prejudice to the penalty mechanism referred to in paragraph 2" essentially distinguishes buy-ins from penalty mechanisms, which suggests that the lawmakers had not intended do design buy-ins as penalty mechanisms. The confusion is furthered by the fact that Level 2 Regulations, unlike Level 1 Regulations say that under the buy-in the securities shall be delivered to the failed to **trading party**.

c) Compensation for price difference

Level 1 Regulation provides for compensation measures where there is a price difference between the price of financial instruments agreed at the time of the trade and the price paid for executing the buy-in. In particular, where the price initially agreed at the time of the trade is higher than the buy-in price, the failing participant shall pay the price difference to the receiving participant. ICMA claims that such mechanism does not restore parties to the economic position they would have been in if the transaction settled but instead produces profit for the receiving participant and created loss for the delivering. Some market participants even assume that the text contains a typo. Perhaps the reason why Level 1 regulation provided for such measures was as follows: suppose the trading party timely receives the financial instruments and sells them immediately, sometime after the sale the price of those instruments falls; now assume the same scenario, only this time the settlement fails and the trading party is no longer able to sell those instruments at the high price it could in the first scenario. But even in this case something is amiss because it is not clear for what is the buyer being compensated. In the first scenario where the financial instruments were sold at a high price, they were already bought at a high price, meaning there is no lost profit to compensate for.

ESMA seems to agree with the erroneous nature of the rule. Level 2 Regulation provides for the opposite: when the price of financial instruments agreed at the time of the trade is ***lower*** than the price paid for executing the buy-in the failing trading party (where the transaction is executed on a trading venue, the trading venue participant and where the transaction is cleared by a CCP, the failing clearing member) shall pay the price difference to the receiving trading party (trading venue member or CCP, who then transfers to the receiving clearing member as

applicable). And this sound logical because now the buyer is compensated for having to buy something at higher price than he would if not for the settlement fail.

OUR GENERAL REMARKS

1) Our overall impression is that initially the purpose of the mandatory buy-in regime, as provided under Level 1 Regulation, was to create incentives for settlement system participants to "police" the enforcement of trades as placing the burden of compensating the trade fail on the participant means that the participant in its turn will pass on the costs to its client, the relevant trading party, and require collateral to ensure the recharge. While drafting the Level 2 Regulation and after a round of consultation with market participants, ESMA acknowledged that such collateralization excessively increases the cost of securities settlement and thus decided to place the buy-in on the trading level (between the trading parties).[22]

2) What's interesting about the responses submitted by the stakeholders to ESMA's consultation is that instead of creating more confidence in counterparty performance due to the costs the buy-in entails in case of non-delivery, the mandatory buy-in rules seem to fuel the anxiety among market participants that they in their turn may default on delivering securities that were owed but not timely delivered to them and thus subject them to a buy-in with all related expenses.

3) Another point to ponder is why do the regulations interfere in a pure contractual relationship of the parties and compel a buy-in, where there is a failure to deliver securities.

4) The last thoughts are on whether the regulations will eventually enter into force? Our humble assumption is they will not. The European Commission launched a targeted consultation on CSDR between December 2020 – February 2021, where the stakeholders took another chance in convincing the regulators and lawmakers to abandon mandatory buy-ins. But of course the exact outcome is something for the future to tell.

[22] https://www.esma.europa.eu/sites/default/files/library/2016-174_-_final_report_on_csdr_rts_on_settlement_discipline_0.pdf , point 149